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PACIFIC TELESIS
Group-Washington

May 9, 1994

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1 - Price Cap Performance Review for Local Exchange Carriers*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

J. A. Goddard

Enclosures

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: May 9, 1994

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SUMMARY

The Commission faces a crossroads today that reminds us of the one that confronted economists and central planners in the Soviet Union in the 1980s -- except for some differences in scope. That is, the fate of the free world doesn't hang in the balance. But maintaining the nation's competitiveness and equality of access for all does.

The early Soviet Union, like the Bell System, was the ultimate seller's market: a command economy. A central planning apparatus in Moscow (much like AT&T and its regulators in America) dictated all production and all prices. In the Soviet Union, almost the only goods whose supply matched the demand for them were the very special outputs of the ministries of defense. Ordinary consumers didn't fare so well. The inevitable discrepancies between production commands and consumer demand, between controlled prices and market prices, showed up as persistent shortages and surpluses.

On that side of the water, comparatively few people outside the government had telephones, and the architecture of the "public" network was kept rigidly hierarchical (for example, all international calls were routed through one operator-assisted gateway in Moscow) to enable eavesdropping.[1] On this side of the water, AT&T succeeded for a time in stamping out the

1 See Eli Noam, Telecommunications in Europe (N.Y., 1992), pp. 284-85.

Hush-A-Phone, a plastic device that attached to the telephone mouthpiece to increase privacy.

These production monopolies worked reasonably well as long as they were surrounded by impregnable walls. In the 1960s the walls began to fall. New suppliers, new information technology, new economic pressures undermined the monopolies. In the Soviet Union, the defense ministries commanded a larger and larger share of the economy, literally starving the consumer sector: for the first time in peacetime, the country had to import large amounts of food. There was little or no inflation but there was little or nothing to buy with rubles, either. "They pretend to pay us and we pretend to work" was the way workers themselves described it.[2] A black market based on hard currency blossomed. Unlike the command economy that made allocations based on political objectives, the black market allocated labor and capital according to the demands of consumers. Workers began to take real jobs in the underground sector to earn real pay, and the productivity of state industries went into decline.

In America it was the mainstream economy that blossomed. The centrally planned sector, AT&T, couldn't keep up with consumer demands. It was hard for AT&T to make investments where needed because historical cost-plus regulation didn't jibe with the reality of inflation. New technology engendered new providers who could undercut AT&T's long distance rates and still

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2 Brooke Unger, "Souls in a New Machine," The Economist, April 16, 1994, p. 3.

make immense amounts of money. There was even a black market of "blue box" resellers of long distance service, for whom the potential for profit outweighed the potential for jail.

In both places it was difficult to get a fix on the problem, let alone what was to be done. In the Soviet Union, the actions of the central planners in the 1960s, '70s, and '80s were consistent with what a pair of 1930s commentators on the Soviet system had called "the bureaucratization of economic life."[3] They tried to apply new and more detailed controls. Consumers were competing for scarce resources with the very organs of control, the defense ministries and the security bureaus, so it was unthinkable that prices or production should be set by consumer demand. Ergo the state needed more planners.

By the mid-1980s, the Soviet planners were attempting to control the prices of over two hundred thousand items. The price controls were not only futile; they speeded the demise of central planning. They were premised on the absence of competition to the state sector -- a false premise. The underground economy became the future and the command economy imploded. That consumers should bring the Soviet Union down was stupendous but not miraculous. The real mystery of the Soviet

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[3] Oskar Lange and Fred Taylor, On the Economic Theory of Socialism (N.Y., 1938), p. 110.

economic debacle was not, as Robert Heilbroner wrote, why it happened but why it did not happen much sooner.[4]

In America, the story, admittedly, has been more complex. On a national level the central planning apparatus for the telecommunications sector was dismantled in part, largely by the historical accident of a lawsuit. (Legislation to overhaul the Bell System never got anywhere). Some competitors were allowed into some telecommunications markets. But there was little consistency. New providers (not the BOCs) were allowed into long distance. Some other markets such as CPE were opened up to all, with restrictions on some (the BOCs). Lines unrelated to technology or consumer demands -- LATA boundaries, state lines -- were drawn in the sand. Oddly enough, at the same time legislators abetted the creation of powerful, exclusive cable television franchises. Not until 1992 did they become concerned about controlling them.

Local telecommunications remained an official part of the command economy. But by the late 1980s the FCC, the larger LECs, and many state commissions had joined in a consensus that command regulation wouldn't work any better in local telecommunications than it had in long distance. In 1986-90 the FCC and many state commissions took the first steps toward dismantling the compact between regulators and the LECs, which had been premised on the absence of competition and the

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[4] For a description of these events see R. L. Heilbroner, "Reflections: The Triumph of Capitalism," The New Yorker, January 23, 1989; and 21st Century Capitalism (N.Y., 1993), p. 97.

sustainability of central planning. It could be debated whether regulators were shaping events or just responding intelligently to events beyond their control. But it was clear that no lines in the sand could withstand the tide of competition and technological advancement.

The interstate price cap rules that took effect in 1991, though muddied with compromises, were a step forward. Burdened as the new rules were with vestiges of the command approach, we believed they made us somewhat more likely to survive the loss of our production monopoly. And there was always 1994, the year of the price cap review.

Then a curious thing happened -- or maybe not so curious to students of history. (As Mark Twain is supposed to have said, history doesn't repeat itself, but it does rhyme.) By fits and starts, local regulators in America's laboratories of democracy, the states,[5] continued to erase restrictions on competition while giving the remnants of the former production monopolies unprecedented pricing flexibility. In California, for example, full intraLATA competition is imminent, pricing flexibility has grown substantially, and we have taken voluntary steps to resell our loops and switch ports to competitors.

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[5] "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.... If we would guide by the light of reason, we must let our minds be bold." New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

But as the FCC authorized competition, it imposed new restrictions on our prices and outputs. We hope there is no analogy to the downfall of the Soviet economy to be played out, because, as the current sole guarantors of universal service, we're the stand-ins for their state-controlled factories. But we may be forgiven if several things that have developed since price caps were first proposed give us pause. New products are generally prohibited without special permission. Prices of existing products are prescribed by complex formulas that are now completely unrelated to economic costs or market demand. Sharing and lower-formula adjustment "backstops" correct for any mistakes. The general direction of changes to the rules has been toward re-regulation. The underlying assumption has been that complex restrictions on price and output will work, because we have a monopoly on production. That assumption is false.

The three diagrams following this Summary illustrate the bureaucratization of our own economic life. In 1989, the Commission was still proposing the price cap structure in the first diagram, which had just two baskets. In 1991, the Commission adopted the price cap structure in the second diagram, which had four baskets, seven bands, and two subindexes. Today, including those in the proposal stage, the structure includes eleven bands, nine subindexes, and six sub-subindexes. (Not displayed on the diagrams are changes and interpretations of the rules on new service filings that have been made over the years to make them reviewable according to more traditional regulatory cost standards. The FCC staff has also taken the position that we may not generally offer new services without their permission, an undisguised limit on output.)

This proliferation in restrictions on prices is actually greater than it appears. Because the baskets, bands, subindexes, and sub-subindexes are factors that are applied against one another, the true increase in attempted price and output control has been exponential. One aspect of this complexity, zone pricing, was intended to let us move away from geographic averaging, and we appreciate the intent. But it remains a price control that's unrelated to cost or demand.

Telephone companies aren't the only ones to notice there's something wrong with this picture. Consider the blunt words of Barry Diller, Chairman and CEO of QVC Inc. We don't always agree with everything Diller says, but we recognize the frustration of a distributor who just wants to deliver his goods to consumers and can't:

> We have a very creaky communications policy in this country -- essentially a system that follows the design of the turn-of-the-century, when railroads had to seek approval for line extensions. What government should do is set a certain date for telecommunications and cable companies to begin their competition with each other. Period. Within this competition, all issues, certainly including consumer pricing, should be naturally resolved. The only overriding issue is to be sure we have at least two "wires" into each home.
>
> Instead we have a lot of excruciatingly complicated regulation that can only produce poor results. No one has a clue about what's going to happen in many of these businesses -- not me, not regulators, not legislators. So the sensible policy ... is to stop

> micromanaging everything and let the parties concentrate on creating full-service broadband networks.[6]

In these Comments we suggest nothing very different from steps the Commission has already taken, or considered taking. Essentially we seek two things.

First, a return to the spirit of price caps. The vestiges of cost-plus regulation and command pricing hurt consumers and penalize investors who would build the network of the future. Sharing and lower formula adjustments should be eliminated. Special applications and lengthy cost-of-service review of new products should become a thing of the past. Exogenous rate adjustments should be limited. The restrictions on our prices, which began innocently enough but grew like Topsy, should be reduced to the fewest number necessary to allay concerns of anticompetitive behavior. For example, grouping together in one basket services that are substitutable for one another and subject to the same amounts of competition eliminates any need at all for further complexity.

Second, the removal of price controls on competitive services in competitive areas. This is essentially the two wire solution that Diller refers to, applied to local telecommunications. Price controls in competitive areas hurt consumers by maintaining pricing umbrellas.

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6 "Toward a Free Market in Telecommunications," Wall Street Journal, April 19, 1994, at A18.

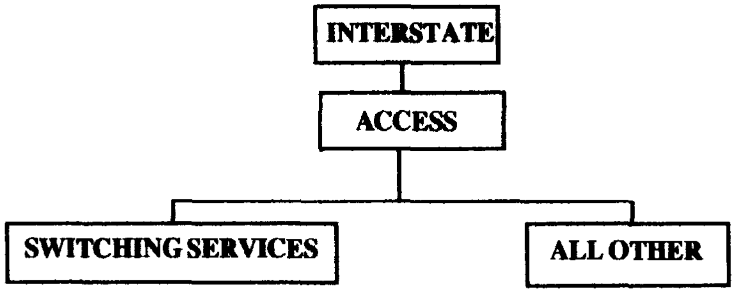
We present evidence we have already lost market power over special access services in major metropolitan areas. These areas, where service has been provided far above cost, make possible below-cost service almost everywhere else. The groundswell has begun. We've lost as much of the special access market in the most profitable areas as it took AT&T nearly two decades to lose in the switched long distance market. And it's happened before intraLATA competition was authorized or a single collocation cross-connect was provided to a CAP.

If anything, our surveys understate the competitive pressures on our rates. A substantial part of our competition is "underground" in more ways than one. Either it's embedded in the existing networks of our larger customer-competitors, or because the Commission doesn't require all providers to report the extent of their networks, it's simply off the radar screen.

The Commission should examine specific markets and streamline regulation in those that are competitive, much as it did when it streamlined regulation of AT&T's Basket 2 and Basket 3 services. Consumers in competitive markets aren't getting everything they want, and they're paying too much for what they get. We also submit expert evidence on the favorable effect that pure price cap regulation for noncompetitive services and streamlined regulation for competitive services would have on the nation's economy. Pure price cap regulation and the regulatory reform for competitive services will create jobs, harness private capital to build the NII, and enhance the nation's competitive preeminence in the global economy.

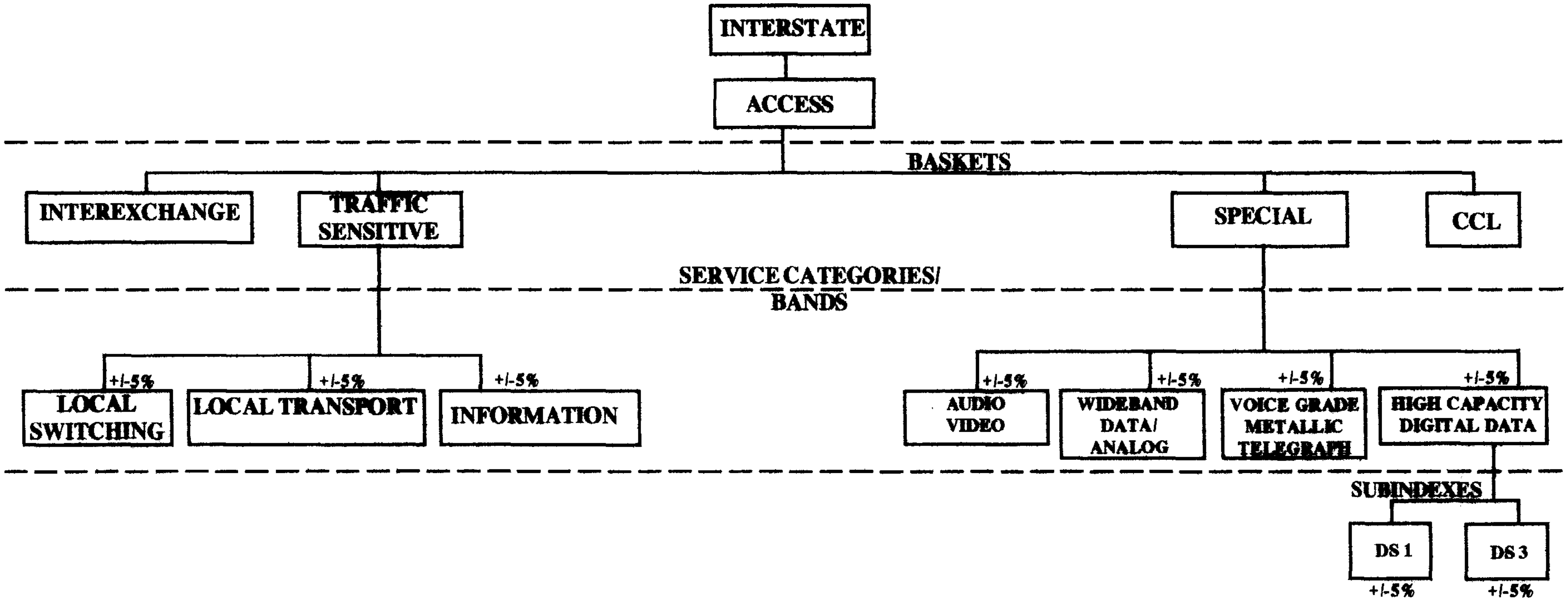
PRICE CAP SERVICE STRUCTURE

(As Originally Proposed)



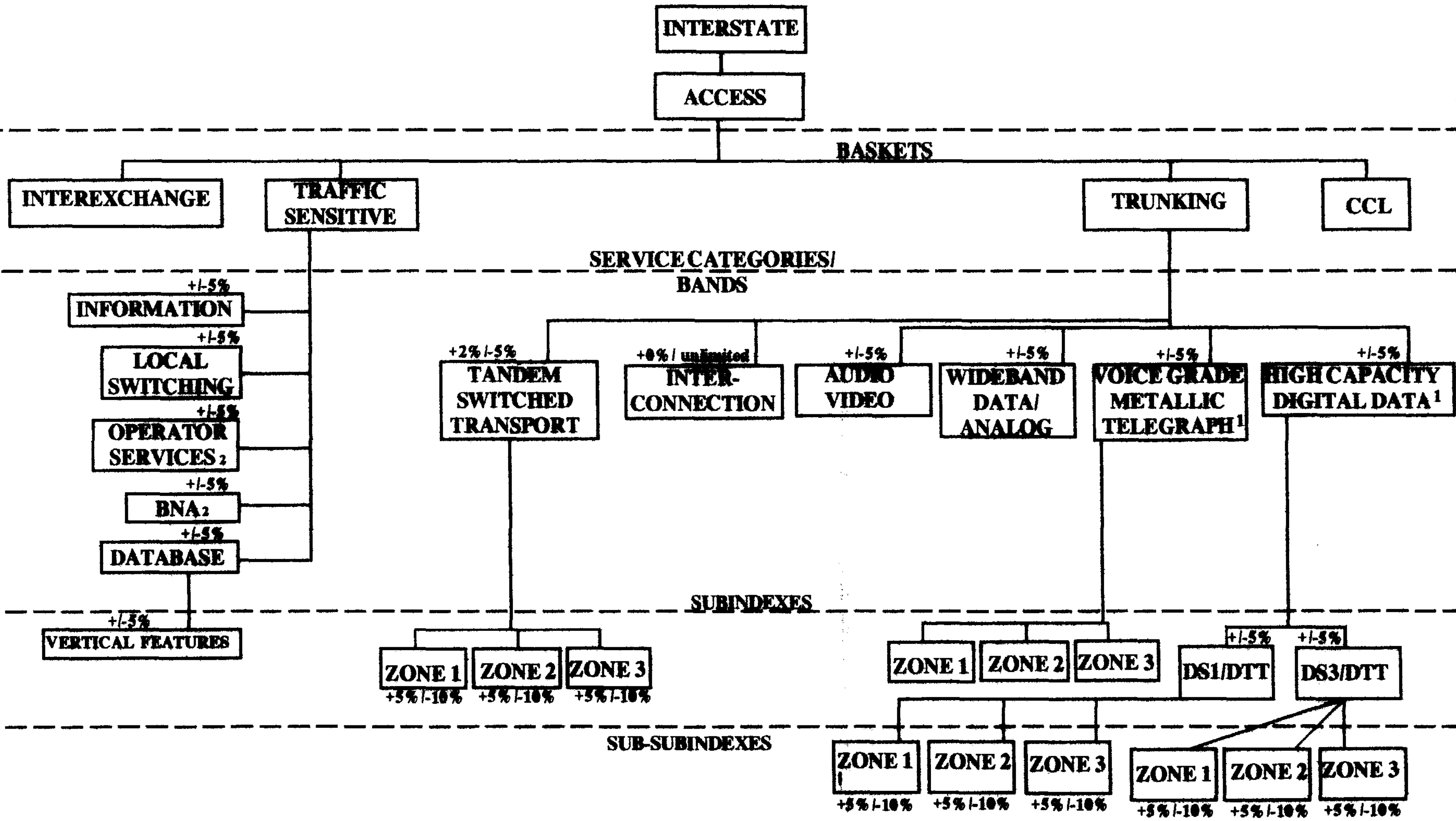
PRICE CAP SERVICE STRUCTURE

(Effective 1/1/91)



PACIFIC BELL
PRICE CAP SERVICE STRUCTURE

Incorporates changes ordered in Second Report & Order in CC Dkt 91-213, released 1/31/94



1 Includes Entrance Facilities and Dedicated Signalling Transport Charges
2 Proposed in CC Dkt. 93-124

CAP 4/14/94

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1

COMMENTS OF PACIFIC BELL AND NEVADA BELL

In accordance with the Notice of Proposed Rulemaking in the above-captioned proceeding,[1] Pacific Bell and Nevada Bell (the "Pacific Companies") hereby submit their Comments on the review of price cap regulation for the LECs.

I. INTRODUCTION: THE PRINCIPLE OF ZERO-BASED REGULATION.

We strongly support price cap regulation of services that are not yet competitive. The problem is that the current rules are not true price cap rules, and they are applied to some competitive services that don't require regulation.

A pure price cap plan would cap prices, but not earnings, and would group services with similar elasticities of supply and demand in as few baskets as needed to prevent cross-subsidies. Because the services in each basket would be

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1 Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Notice of Proposed Rulemaking, FCC 94-10 (released February 16, 1994) ("Notice").

cross-elastic and subject to similar levels of competition, there would be no need for pricing bands. To promote efficient pricing and contribution to consumer welfare, competitive services would be removed from regulation in markets where customers have competitive alternatives.

The Commission came close to adopting real price caps in the 1980s, when it proposed rules for LECs that included no sharing and only two baskets, and indicated a willingness to encourage new services by exempting them from traditional cost review.[2] But the plan it ultimately adopted was cumbersome to administer and retained many undesirable vestiges of rate of return ("ROR") regulation. For example, sharing and the lower formula adjustment mechanism ("LFAM") (collectively the "backstop mechanisms") were included that blunt the incentive to be efficient and may even, by pooling earnings from competitive and noncompetitive services, promote cross-subsidies.

Since 1990 even more ROR features have crept back into the rules. Due to a proliferation of new bands, sub-bands, and sub-sub-bands called "zones", price caps has changed from a system designed to promote change to a way to slow it down. Yet because of rapid advancements in technology and competition, the reasons for pure price caps are more compelling now than ever.

The proposal we present in these Comments has two aspects. First, the single most powerful incentive the Commission could create to stimulate economic growth and create

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[2] See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873 (1989).

jobs, to increase consumer welfare, and to allay fears that price cap carriers will behave anticompetitively in the new landscape, would be to create a pure price cap plan for services not yet subject to competition. That means no backstop mechanisms, no exogenous adjustments except for the effects of accounting changes or rule changes adopted by the Commission, a realistic approach to productivity gains, reform of new service rules, and forbearance from regulation for services in contestable markets.

Second, regulation should be applied on a zero basis: only when its benefits outweigh the costs of lost efficiencies and reduced consumer welfare. Price cap regulation should facilitate the outcomes that occur in markets that do not need regulation, so that firms produce their services for the least possible cost and consumers pay prices that reflect the cost of the services they use. Consumers respond to economic incentives, not to the wishes of legislators or regulators, however well-intended. Regulation applied unequally or unnecessarily distorts those incentives and harms consumers.

Pure price caps would do an admirable job of passing the zero-based test in markets that are not competitive. But what we have isn't pure price caps, and it has been applied to competitive markets. The current rules penalize investments in the network of the future, the National Information Infrastructure (NII). Building the NII requires, in Eli Noam's words, "an end to the nostalgia for the simplicity of the golden age, a vision of a very different network environment, and the willingness to engage in analysis that goes beyond that of competition versus monopoly, because most future issues cannot be analyzed in such simple terms."[3] More to the point, building the NII will require enormous expenditures of capital.

In competitive markets, the Commission does the most for consumers by avoiding regulation-as-usual. Where consumers have alternative choices of supply, such that no one firm can raise prices above competitive levels, regulatory intervention fails the zero-based test. The Commission has long recognized the superiority of market forces to regulation in competitive markets.[4] Indeed, the Commission's greatest successes have resulted from decisions to refrain from regulating markets with more than one supplier, such as CPE, inside wire, cellular, and LEC billing and collection service. Well-entrenched interests with a stake in the status quo will always object to real reform as going too far and risking too much. In every one of these cases they made such objections, and they were wrong. In every one of these cases costs fell, prices fell, and consumer choices increased, all without any apparent anticompetitive activities by the incumbent players.

The Commission has an opportunity in this proceeding to repeat those successes on a grander scale. We invite the Commission to let us submit information about the extent of competition in each of our wire centers, to collect basic

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[3] Eli Noam, Telecommunications in Europe (New York, 1992), 43.

[4] See for example Rates for Competitive Common Carrier Services, 85 F.C.C.2d 1, 33 (1980).

evidence from our competitors about the extent of their business, and to allow streamlined regulation in specified areas based on sound economic principles.

The Commission demonstrated most recently in Docket 90-132 that it has the ability to analyze markets in this way. It only needs to define relevant markets in terms of products or services and geographical areas,[5] then determine whether customers have competitive choices or (conversely) that one provider has "the ability to restrict output or raise price over what would prevail in a competitive market, and maintain it over time."[6]

Even if the geographical areas in which customers have competitive choices are small compared with the total size of our franchise, the ability for us to compete fairly in these competitive areas is extremely important to the health of the greater number of markets where we face little or no competition. A small part of our serving area produces the lion's share of the profits that keep the entire franchise afloat. So long as we lack real pricing flexibility, consumers in competitive areas will pay too much.

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[5] See for example Illinois Bell Tel. Co. v. Haines and Co., 905 F.2d 1081 (7th Cir. 1990).

[6] Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, 5 FCC Rcd. 4962, 4968 n.19 (1990).

Because of geographic averaging, separations, current price cap, and other rules, there are many other markets where our forward-looking costs exceed our revenues. Our competitors will have no interest in entering these markets so long as the rules keep our rates there below cost. The more that competitive conditions change but the rules don't, the more these high-cost markets become a burden to us. Competition for the few but lush high-profit markets and customers will continue to increase. The Commission will have to make a corollary change in the way that service is assured in noncompetitive, high-cost markets: rates there must increase, or "carrier of last resort" obligations must be shared with our competitors, or a new source of contribution to below-cost rates must be found, or all of the above.

As the Commission observed in the Special Access Collocation Order,

> "(e)xcessive constraints on LEC pricing and rate structure flexibility will deprive customers of the benefits of competition and give the new entrants false economic signals."[7]

The longer constructive reform is delayed, the more difficult it will become, as competitors grow and develop vested interests in the perpetuation of unnecessary regulation. The temptation to take half-steps toward competition and exercise "caution" will be

[7] Expanded Interconnection with Local Telephone Company Facilities, 7 FCC Rcd. 7369, para. 172 (1992)

urged on the Commission by all those who fear competition. They should not be listened to. They have no interest in real reform.

II. GENERAL ISSUES: THE NEED FOR PURE PRICE CAP REGULATION OF SERVICES NOT SUBJECT TO COMPETITION.

In the Notice, the Commission requests comment on a number of "General Issues." It asks whether "the basic goals of price caps remain valid." Notice, para. 33. It requests comment on whether the Commission should revise the goals of the LEC price cap plan so that the plan may better achieve the purposes of the Communications Act and the public interest, and if so what should be the revised goals. It also asks "[w]hat has been the effect of the price cap plan on consumer welfare, the economy, and the creation of jobs both in telecommunications and in other sectors of the economy ... [and] in the future." Id., para. 34.

The goals of price cap regulation remain valid. Price cap rules create the strongest incentives for carriers to invest and operate efficiently, while reducing their ability and incentive to behave anticompetitively. But the "incentive regulation" scheme the Commission adopted in 1990, and has added various complications to since, isn't price cap regulation. The benefits of price cap regulation are the following:

First, pure price cap regulation directly attacks the primary efficiency loss from unregulated monopoly pricing: the dampening of demand due to the high monopoly price. Second, by eliminating the cost-plus feature of ROR regulation, pure price cap regulation rewards efficiency gains with higher profits.

Third, by doing away with automatic recovery of any investment in the rate base, pure price caps forces carriers to invest more wisely. Pure price cap regulation would free us to behave in an economically rational way, receiving whatever rewards the market will allow, without exposing captive ratepayers to the risk of underwriting unsuccessful ventures. Fourth, since prices are easier to measure and track than costs or earnings, pure price cap regulation reduces the administrative costs of regulation. Fifth, pure price cap regulation prevents cross-subsidies from monopoly services to competitive ventures. Sixth, pure price cap regulation permits price flexibility within baskets which lets us respond to changes in the competitive environment in the same way as our unregulated competitors.[8]

Calling the current rules "price cap" or "incentive" regulation is a misnomer. The rules create perverse incentives for investors, carriers, and consumers to behave uneconomically. By sending the wrong signals the current rules depress desirable economic activity, encourage uneconomic activity, and reduce overall consumer welfare. They kill jobs, and they will discourage private investments in the NII.[9]

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[8] See R. G. Harris, "The Economic Benefits of LEC Price Cap Reform," filed with USTA's Comments in this docket.

[9] Id.

III. BASELINE ISSUES: REVISE THE PRICE CAP RULES FOR EXISTING SERVICES THAT ARE NOT FULLY COMPETITIVE.

The Commission also seeks comment on the following "Baseline Issues." Notice, para. 36.

A. Universal Service and the NII.

Baseline Issue 1a: Whether, and if so how, the Commission should revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure (NII).

The best and lowest-risk approach to building the NII would be simply to remove the present disincentives to doing so. These disincentives include the sharing mechanism (which taxes the returns on any investment in the network, and makes other investments seem artificially more attractive); arbitrary reductions to revenues (such as the current productivity factor), which reduce internally generated funds that could be used to make productivity-enhancing investments; and restrictions on pricing flexibility and new service offerings, which penalize consumers and retard innovation and responsiveness.

We believe the biggest disincentive to building the NII lies in the backstop mechanisms. They confer artificial advantages and disadvantages on the current providers: we suffer from earnings limitations our competitors don't have, which increases our cost of competing. Our competitors don't have the assurance of the LFAM, which increases their business risk relative to ours. While leveling the playing field to put us and our competitors on the same footing, eliminating the backstop mechanisms would also remove a great disincentive to efficiency and investment.

Earnings limitations discourage investments in the American network of the future by expressly limiting the potential return to investors. The potential telecommunications investor will compare the returns on regulated services in America to unregulated services, as well as the returns available in America (where earnings are limited by the price cap rules) to the returns available elsewhere (such as Japan, Germany, or the U.K., where earnings are essentially unlimited). It takes little financial acumen to realize that investing in the regulated services of the LECs will probably not produce the greater return.

In earlier decades it might have been said that the low return realized by the LEC investor was commensurate with low risk. That's no longer the case. Investors perceive our level of risk to have risen (see below, p. 39). They expect a commensurate return -- a return which, with sharing limitations, is difficult to provide them no matter how efficient we become. It should come as no surprise if investors see more risk in our business than the Commission does. Investors focus on future returns, not past returns. They know that even greater competition will develop tomorrow. From their point of view, waiting for some ideal degree of competition to "develop" before making substantial changes to the rules would be closing the barn